Perspectives
Financial Markets

SwissLife
Asset Managers

February 2019

Interest rates & bonds

Recession averted or dead cat bouncing?

USA

- More dovish tones from the US Fed coupled with the hope for a solution in the ongoing trade war between the US and China led to a reversal in risk sentiment since the beginning of the year
- Credit spreads in investment grade and high yield tightened materially while treasury bonds were in less demand as investors piled into risky assets
- Although markets have largely priced out rate hikes, we still expect the Fed to deliver two hikes in 2019

Eurozone

- Data out of the Eurozone continues to disappoint, with Germany likely narrowly escaping a technical recession and Italian industrial production plummeting
- The political situation remains in flux, keeping risk premia elevated
- We do not foresee the ECB to change its deposit rate before late 2019

Japan

- The BoJ decided to stay on course with their monetary policy, including yield curve control
- The BoJ lowered the inflation forecast at its last meeting, but we expect unchanged monetary policy going forward

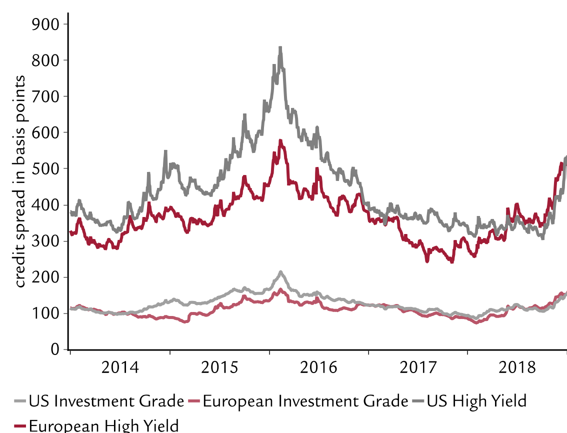
UK

- The Brexit drama continuous to drag on with every possible outcome, including a second referendum, still in the cards
- We expect the BoE to remain cautious for the time being, but currently find less value in GBP credits given the political uncertainty

Switzerland

- Economic data point to a slowdown, while inflation in December decreased again
- We currently see limited room for 10-year government bond yields to move materially upwards in the near term

Credit spreads have tightened at the start of 2019



Although 2019 is off to a remarkable start in financial markets, we remain cautious as the political risks that dominated much of last year are still in place. The Brexit issue is far from resolved. While we still think that a negotiated transitional period is the most likely final outcome, the risk scenarios of a "hard Brexit" as well as a second referendum are still on the table. Trade talks between the US and China are currently showing progress, but they could still lead to nowhere or blow up any minute given the volatile nature of the Trump administration. On top of it, the US government shutdown has increased the downside risk to our already cautious 2.3% GDP growth forecast for 2019. However, we are also seeing positive signs. While arguably the global economy is slowing, corporate earnings so far have been relatively good with the majority of companies beating estimates in the US. In addition, the US Fed seems to have become more data dependent, while the ECB, BoJ and BoE will likely keep their loose monetary policy in place for the time being. China, which has seen its slowest growth since the financial crisis, is putting more liquidity into the system while simultaneously creating more fiscal stimulus. Although the current rally in risky assets might still have some room to run in the short term, we use the friendly environment to position ourselves more defensively on the credit side, while keeping a neutral to slightly short duration position.

Equities

Reversal of exaggeration

USA

- Even though the US is facing the longest government shutdown in history, markets have so far been largely unfazed
- In the next round of trade talks scheduled for January 30-31, China is said to offer a path to end trade imbalances with the US by 2024. Any relief in this matter will likely support US equities
- The Fed signalled to slow its rate hike cycle, which calls for a moderate upside potential of equity markets despite still relatively high earnings expectations

Eurozone

- The ongoing Brexit discussion contributes to uncertainty in Eurozone equity markets
- The ECB is confronted to timely address monetary tightening pressure coming from 489 bn EUR of TLTRO loans maturing in 2020
- If the program is not prolonged, the implied liquidity withdrawal could lead to higher borrowing costs faced by businesses and households, which would have a negative impact on EMU equities

Japan

- The Japanese market has slightly underperformed global equities over the past two months, mainly as a result of the stronger JPY

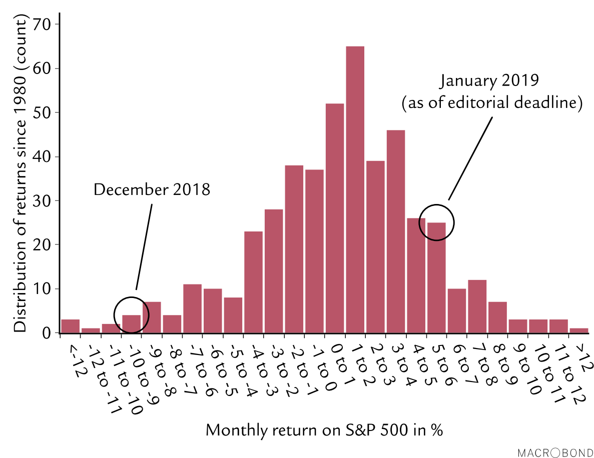
UK

- The UK parliament clearly rejected the government's EU withdrawal agreement. The political uncertainty is weighing on UK equities
- UK small caps should in principal be hurt most by the latest Brexit developments. However, small caps reverted their negative December performance as they tend to benefit most in strongly positive market environments

Switzerland

- In Switzerland, we expect small caps to outperform, recovering some of last year's underperformance against the SMI

Both December and January posted extraordinary returns



After the multi-year equity bull market, which was supported by strong economic fundamentals, volatility has returned and equity markets are searching for their new equilibrium. Given that there is no previous experience on how the US Fed's reduction of the balance sheet (so-called quantitative tightening, QT) will influence markets, expectations are spread widely among market participants. This, at least partially, explains the large fluctuations seen over the past months. After a vastly disappointing December, January has recovered some of the losses (see chart above). At the start of the year, the Swiss market has interestingly shown one of the strongest performances. As per 24 January, the SMI is up 6.0% year-to-date, more than the S&P 500 (+5.4%), the Euro Stoxx 50 (+4.2%), the Nikkei 225 (+2.8%) or the FTSE 100 (+1.4%). Also remarkable are emerging market equities which were down substantially last year and strongly recovered in January by 5.6%, as measured in USD terms and as of 24 January. As much as there was no reason to panic in December, there is no real foundation for a lot of euphoria right now. In contrast, it seems likely that this volatile "normalisation" will stay with us for a while given elevated uncertainties around the economic and political outlook.

Currencies

Euro to remain under pressure

USA

- Despite the return to a risk-on mood in financial markets, the USD has remained strong in January as US economic data continued to outperform
- Even though financial conditions have loosened, markets are pricing out any monetary policy action in the US this year
- Re-pricing of Fed policy rate hikes might provide further support for USD going forward

Eurozone

- Political risks related to Italy have moved to the backburner, but are likely to flare up again going forward
- The ECB reiterated its dovish stance in its January meeting, with President Draghi highlighting downside risks to the economic outlook
- We think a negative premium on EUR is still warranted due to weak economic momentum, political risks and continued monetary policy divergence

Japan

- JPY has moved sideways against the USD year-to-date, in line with our neutral view on the currency pair
- Interest rate spreads should favour USD, but improved safe haven correlation coupled with the potential of BoJ normalization represent an upside for JPY

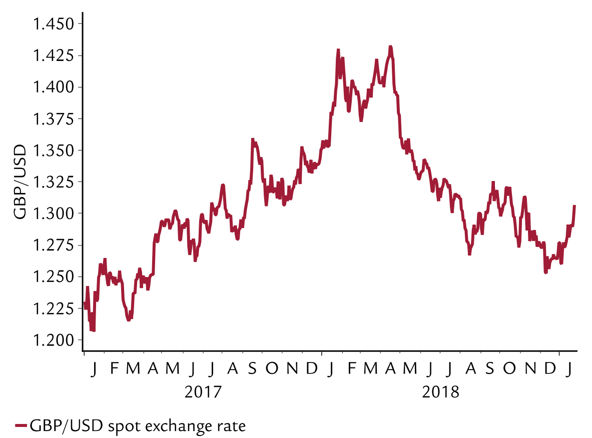
UK

- GBP has rallied over the past month, as markets see a "no-deal" outcome as less likely
- While we believe that a transitional period ("blind Brexit") remains the most likely scenario, the way to get there is extremely rocky given the political chaos in the UK. We thus keep a negative view on GBP

Switzerland

- CHF traded sideways against EUR, but weakened against USD since beginning of the year
- Switzerland's economy is vulnerable to a slowdown in the Eurozone. Hence, we do not expect any move by the SNB ahead of the ECB
- With a lot of negative expectations probably already priced, we keep a neutral view on EUR/CHF

Sterling regaining lost ground



The significant improvement in financial market risk sentiment since the start of 2019 has barely been reflected in foreign exchange, with the exception of rallying emerging market currencies. Indeed, safe have currencies such as JPY and CHF have not lost any ground against USD and EUR, respectively. Meanwhile, the EUR depreciated further against USD. We expect the EUR to remain under pressure. First, leading indicators paint a dismal picture for Eurozone manufacturing, while economic indicators have remained very solid in the US. Second, while both the US Fed and the ECB have struck a more dovish tone recently, we only expect the Fed to deliver interest rate hikes over the next 9 months – a scenario not yet priced by markets. Last, political risks related to Italy, to Brexit and to potential US tariffs on European cars warrant a risk premium for the EUR. Meanwhile, Sterling has posted a stellar performance even though the outlook on Brexit remains as cloudy as ever. Markets took two developments positively. First, the massive rejection of the withdrawal agreement in the UK parliament has left the door open for a potential "no Brexit" scenario. Second, there are increasing signs that parliament will put procedures in place to avoid a "no deal" Brexit. While we still believe that some form of negotiated exit ("blind Brexit") will prevail in the end, things will probably need to get worse before they get better. Hence, we prefer to keep a negative view on Sterling at this point in time.

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